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No. 79-980

In the Supreme Court of the United States

OCTOBER TERM, 1979

MORTON-NORWICH PRODUCTS, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Claims (Pet. App. 1a-22a) is reported at 602 F. 2d 270.

JURISDICTION

The judgment of the Court of Claims was entered on July 18, 1979 (Pet. App. 1a). The Court of Claims denied a petition for rehearing en banc on September 28, 1979 (Pet. App. 1b; Pet. 1). The petition for a writ of certiorari was filed on December 21, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Whether interest on a federal income tax deficiency resulting from an adjustment made under Section 482 of the Internal Revenue Code of 1954 runs from the date the return was due to be filed, or from the date of notice and demand for payment of the deficiency.

STATEMENT

Petitioner is the parent of an affiliated group of corporations. During its taxable years ended June 30, 1965 through 1973, petitioner made interest-free loans to its wholly-owned foreign subsidiaries. On audit, the Commissioner of Internal Revenue adjusted petitioner's gross income for each of these years by imputing interest on the loans it had made to its subsidiaries at the rate of five percent per annum. This adjustment, as well as correlative adjustments with respect to the wholly-owned subsidiaries, was made pursuant to the Commissioner's authority to allocate income and deductions among related entities in order clearly to reflect their income (Pet. App. 3a).

Petitioner filed a petition in the United States Tax Court seeking the redetermination of the deficiencies determined for the years 1965-1967. That proceeding was thereafter dismissed by stipulation in accordance with a settlement agreement reached by the parties as to the proper amount of adjustment for each year in issue. The parties also agreed as to the proper amount of adjustments for 1968-1973. The settlement agreements, however, did not resolve the question of petitioner's liability for interest with respect to the deficiencies for any of the years in question (Stip. in Ct. Cl., para. 4 and Ex. A). The Commissioner assessed interest on the deficiencies computed from the dates that petitioner's returns for the years involved were due to be filed. Petitioner paid these assessments of interest and brought this refund suit, contending that the interest on the deficiencies should be computed only from the date of notice and demand for payment (Pet. App. 3a). The Court of Claims upheld the Commissioner's position that the interest ran from the date the returns were due to be filed (Pet. App. 3a-11a).

ARGUMENT

The Court of Claims correctly held—in this case of first impression (see Pet. App. 2a)—that interest on an income tax deficiency resulting from an adjustment to gross income under Section 482 runs from the date the return for the year in question was due to be filed and not from the date of the notice and demand for payment.

Under Section 6601(a) of the Internal Revenue Code of 1954, interest on a deficiency runs from the last date prescribed for payment of the tax to the date of payment. Payment of the tax is due on the date the return is required to be filed. Section 6151(a) of the Code. If, on the other hand, no return is required and no other date is specified, then the last date for the payment of the tax, for purposes of computing interest, is the date the liability arises, not later, in any event, than the date of notice and demand for payment. Section 6601(b)(4) of the Code. Section 6601(e)(3) similarly provides that interest in respect of any "assessable penalty, additional amount, or addition to the tax" runs only from the date of notice and demand.

Here, petitioner made interest-free loans to its wholly-owned subsidiaries. On audit, the Commissioner determined that, if petitioner had conducted the transactions at arm's length, it would have charged interest on these loans. The Commissioner therefore made the necessary adjustments to petitioner's gross income reflecting interest from these loans in accordance with Section 482. That provision permits the Commissioner "to deny [to taxpayers] the power to shift income * * * arbitrarily among controlled corporations, and to place such corporations rather on a parity with uncontrolled concerns." *Central Cuba Sugar Co.* v. *Com-*

missioner, 198 F. 2d 214, 216 (2d Cir.), cert. denied, 344 U.S. 874 (1952). See also B. Bittker & J. Eustice, *Federal Income Taxation of Corporations*, para. 15.06, at 15-16 (1979 ed.). In applying Section 482, the Commissioner employs an arm's-length standard to reconstruct the transaction. See Treasury Regulations on Income Tax, Section 1.482-1(b)(1) (26 C.F.R.).

As this Court observed in *Manning* v. *Seeley Tube & Box Co.*, 338 U.S. 561, 566 (1950), interest is assessed against the taxpayer on underpayments on the theory that, until actual payment, he "had the use of funds which rightfully should have been in the possession of the United States." See also *United States* v. *Northwestern Mutual Ins. Co.*, 315 F. 2d 723, 725-726 (9th Cir. 1963). The adjustments made by the Commissioner pursuant to his authority under Section 482 simply put petitioner and its subsidiaries in the same position as if the transactions within the controlled group had been at arm's length. The Commissioner thereby placed these controlled taxpayers on a parity with uncontrolled taxpayers.

"As in the case of any other audit adjustment, etc.," the Section 482 adjustment is designed to reflect the proper amounts of gross income, deductions, allowances and credits on which petitioner's income tax should be computed. Since that tax was due to be paid on the date the return for each of the years in question was due to be filed, the resulting deficiency does not fall within the terms of any of the provisions of Section 6601 that would delay the accrual of interest until notice and demand for payment occur. Indeed, as the court below noted (Pet. App. 7a-8a), the adoption of any other rule with respect to interest on deficiencies resulting from a Section 482 adjustment not only would allow the taxpayer the interest-free use of funds that properly belong to the government but would undermine the purpose of Section 482 by giving controlled groups an unfair advantage over unrelated businesses. Cf. *Central Cuba Sugar Co.* v. *Commissioner*, *supra*.

2. In seeking review by this Court, petitioner acknowledges that the case presents a "novel" issue (Pet. 7), but nevertheless contends that the decision below conflicts in principle with *Motor Fuel Carriers, Inc.* v. *United States*, 420 F. 2d 702 (Ct. Cl. 1970); *Ray E. Loper Lumber Co.* v. *United States*, 444 F. 2d 301 (6th Cir. 1971); and *Bardahl Mfg. Corp.* v. *United States*, 452 F. 2d 604 (9th Cir. 1971). Those cases, however, involved the wholly different question whether interest on accumulated earnings taxes assessed under Section 531 of the Code should run from the date of notice and demand, or from the date that the return was due for the year in question. Those decisions hold that the accumulated earnings tax is an "addition to the tax" or "additional amount" with respect to which interest runs only from notice and demand under the specific provisions of Section 6601(f)(3) of the Code (now Section 6601(e)(3)). In so ruling, both the Court of Claims and the Sixth Circuit alternatively relied on the fact that the accumulated earnings tax imposed by Section 531 is payable only on notice and demand because it is not self-assessing (it is not reportable on the corporate tax return form). Hence, interest on a Section 531 assessment would begin to run only from the date of notice and demand in any event under the general rule of Section 6601(a).

Here, the Court of Claims correctly noted (Pet. App. 5a) that income tax assessments resulting from Section 482 adjustments and Section 531 accumulated earnings tax assessments are not truly comparable. The accumulated earnings tax is a separate and distinct additional tax that has been characterized as a "penalty" imposed on corporations for failing to distribute earnings accumulated beyond the reasonable needs of the business. On the other hand, a Section 482 adjustment to gross income, deductions, allowances or credits does not result in the imposition of a separate, additional tax,

but simply increases the amount of the ordinary income tax that was due and payable when the return was filed. Nor can an adjustment under Section 482 be considered a "penalty" in any sense. It merely operates to place the controlled group on a parity with uncontrolled taxpayers, thereby precluding a controlled group of taxpayers from obtaining a tax advantage through intercompany transactions at less than arm's length. The resulting deficiency thus simply represents an underpayment of the income tax that would have been due in the first instance had the parties been dealing at arm's length.

In sum, petitioner errs in contending (Pet. 17-21) that a Section 482 adjustment differs from other adjustments in income taxes because the taxpayer may not invoke Section 482 to amend its prior returns. See *Interstate Fire Ins. Co.* v. *United States*, 215 F. Supp. 586 (E.D. Tenn. 1963), aff'd, 339 F. 2d 603 (6th Cir. 1964). This circumstance does not transform the adjustment into a separate tax, imposition of which must be initiated by the government. Apart from the somewhat broader discretion granted to the Commissioner under Section 482, his authority to make such adjustments necessary to prevent evasion of taxes or clearly to reflect the income of the members of the controlled group is not substantially different from the other means available to the Commissioner to adjust income and deductions as reported by the taxpayer in order to determine proper income tax liability. See Eustice, *Tax Problems Arising from Transactions between Affiliated or Controlled Corporations*, 23 Tax L. Rev. 451, 452-463 (1968). Indeed, the principle that the taxpayer may be bound to the form in which he chose to cast his transactions (even

though the Commissioner is not) is in no way unique to Section 482. As this Court observed in *Commissioner* v. *Nat. Alfalfa Dehydrating*, 417 U.S. 134, 149 (1974)—

> while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, * * * and may not enjoy the benefit of some other route he might have chosen to follow but did not.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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